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# Testimony of the American Institute of Certified Public Accountants before the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs, United States Senate, April 19, 1977

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TESTIMONY OF THE  
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
BEFORE THE  
SUBCOMMITTEE ON  
REPORTS, ACCOUNTING AND MANAGEMENT  
OF THE  
COMMITTEE ON GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE  
APRIL 19, 1977

Mr. Chairman, members of the Subcommittee:

My name is Michael N. Chetkovich. I am the Chairman of the American Institute of Certified Public Accountants, the national organization of certified public accountants which represents 130,000 members. Accompanying me today are Mr. Wallace E. Olson, the President of the Institute, and Mr. Theodore C. Barreaux, Vice President in charge of the Institute's Washington office.

We welcome this opportunity to appear before you on behalf of the Institute and to participate in these important hearings to examine the accounting profession and its responsibilities to the public, and to consider what might be done to improve the quality of financial reporting. We regard these hearings as a unique opportunity for the accounting profession to speak to you and the public about its role in our society.

As you know, the Institute has previously submitted to the Subcommittee members a memorandum dated March 28, 1977 responding to the various recommendations contained in the staff study. We would appreciate having that memorandum incorporated in the record of these proceedings.

We believe that a careful and fair reading of this document will convince you that the problems identified by the staff study are not of the magnitude to justify the recommendations for a dominant government role of the nature proposed.

We do not assert, however, that the staff study is without merit. Many of the problems identified are real and well recognized by the profession. It is our hope that our testimony today and our memorandum will persuade you that the profession has responded and continues to respond to these concerns in a responsible manner and that continued reliance on a cooperative effort between governmental agencies and the profession offers the greatest opportunity for their full resolution. This cooperative relationship has served this Nation well in the development of a disclosure system which is second to none in the world and has contributed greatly to the maintenance of the integrity of our capital markets and this Nation's economic strength.

Nonetheless, we acknowledge that there is room for improvement in this rapidly changing and dynamic arena. Accordingly, we welcome the opportunity to work with the members of this Subcommittee and the Congress at large to develop means which will further our common objectives of enhancing the quality of financial reporting. To the extent that the staff study contributes to that effort and serves as a basis for opening a free and constructive dialogue between members of the profession and government policymakers dedicated toward that end, it will serve a highly useful and commendable purpose.

With that objective in mind, this testimony is not intended to restate a point by point refutation of the staff study, but rather will attempt to describe the perspective from which we believe the critical issues posed by the staff should be examined.

I believe we would all agree that it is imperative, in making this analysis, to consider the situation as it is today and not as it may have been five or ten years ago, particularly since we have dealt with the problems of that era in a manner which should prevent their reoccurrence. Our economy, and the role of the participants in it, including the accounting profession, are subject to continual and significant change. Thus, evaluations and conclusions are constantly evolving and judgments which might have been valid at one time are not necessarily so later.

These hearings occur during a time when the roles and the performance of all of our institutions are being questioned, probed and tested for their adequacy. This is a vital part of our democratic process and, in this instance, it has been spurred by events of the last decade which have been sobering and shocking, not only in government, but in the business world as well. During the so-called "go-go" years of the late 1960s, sophisticated and unsophisticated investors alike, were caught up in a speculative fervor,

perhaps second only to that which pervaded the country in the late 1920s. In this period, investors favored the stocks of companies which actively sought out mergers and acquisitions and which displayed an impressive pattern of growth in earnings. Business activities and transactions developed which either were entirely new or had been previously encountered only infrequently. In that environment, the principal objective at times was a desire to increase reported earnings, rather than to report economic reality.

Unquestionably, during that time there were instances where there was more than one permissible method of accounting for a given set of economic facts and some managements selected an available option principally because it afforded a more favorable portrayal of their companies' activities. Also, there were instances in which auditors were less demanding or rigorous than they might have been in reviewing companies' accounting practices, and others in which auditing procedures did not achieve their purpose because of simple human error or bad judgment.

The accounting profession must assume some responsibility for these inadequacies. This, however, should be viewed in the perspective of its overall performance.

During the past decade hundreds of thousands of audits were performed each year, more than 65,000 by the "Big Eight"

firms alone. Also, approximately 10,000 companies submitted audited financial statements each year to the Securities and Exchange Commission. The number of cases in which shortcomings in accounting or auditing contributed to corporate failure and significant shareholder losses has been infinitesimally small in relation to these totals.

Nonetheless, we do not make light of these failures and the incidence of even a few is a cause for concern. We have taken a number of steps to further strengthen accounting and auditing standards and lend greater reliability to audited financial statements.

Before appraising those efforts or assessing past shortcomings, we would suggest that some basic facts should be kept clearly in mind.

First, the financial statements of a company are prepared by and are the representations of its management. Moreover, management maintains the records that underlie the statements and is responsible for recording the transactions in which the company engages. Thus, whenever there are false or misleading statements, the initial responsibility is that of the management which prepared them.

Second, often the auditor is the first victim of a management fraud: a transaction is not recorded; management collusion frustrates the system of internal control; an affiliation

with another party to a transaction is concealed; documents are forged. The techniques and skills of the auditor, and his resources, simply cannot unfailingly discover such fraudulent practices, particularly when they are cleverly constructed to resist the probings of the auditor.

Third, the auditing process, like business itself, is constantly evolving, responding to the total experience of the profession and business, and seeking means of further enhancing the integrity of the financial reporting process. This evolutionary process has accelerated significantly in the last decade. While we might wish that we could anticipate and protect against every conceivable method of fraud and deception, it is not humanly possible to do so.

Fourth, there always will exist within the accounting and auditing process the possibility of human error, oversight, or imperfection. The risks of human failure can be -- and have been -- significantly reduced by improved quality control and better training, but there is no reasonable way that they can be totally eliminated.

We suggest that the real question this Subcommittee should consider is whether the concerns with accounting and auditing practices expressed in the staff study are being effectively dealt with by the Financial Accounting Standards Board, the SEC and the accounting profession, each performing its role in the financial reporting process.



The staff study alleges that the SEC has improperly delegated its authority over accounting matters to the private sector. The FASB and its predecessors have taken the initiative in establishing financial accounting standards. The record shows, however, that the SEC has often initiated the development of standards and has not hesitated to step in and take action on its own whenever it has felt that this procedure was not yielding satisfactory results. In addition, the SEC makes very effective use of the ample opportunities for expressing its views to the standard-setting bodies. The arrangement complained of in the staff study has existed for almost 40 years without any public dissent from any SEC chairman, commissioner or chief accountant and with the full knowledge of all sectors including the Congress.

We believe that in fact investors and the public are being well served by the present system and that the system is working and holds the promise of functioning even better in the future. I would like to cite for you our reasons for this belief.

Since 1939, the profession has been engaged in refining accounting standards and in reducing the accounting options available in the preparation of financial statements, first through the Committee on Accounting Procedures, then through the Accounting Principles Board, and now through the Financial Accounting Standards Board. The FASB was organized in 1973 after a committee appointed by the AICPA and headed by former SEC Commissioner Francis M. Wheat, recommended such an organization to provide broader participation in the development of financial accounting standards. Recently the Financial Accounting Foundation, the "parent" of the FASB, directed its

Structure Committee to re-examine the procedures and work of the FASB. This group has conducted an extensive study of the financial accounting standard setting process. You may be sure that its findings and recommendations will receive prompt attention by all concerned.

At about the same time as the Wheat Committee was formed, the Institute also appointed another committee under the chairmanship of the late Robert M. Trueblood, a highly respected member of the profession, to make an in-depth study of the objectives of financial reporting. This committee made significant recommendations which the FASB is now considering in connection with its study of the conceptual framework of accounting.

Over two years ago, recognizing an apparent gap between the auditor's conception of his role and the expectations of the public, the Institute appointed an independent commission headed by Manuel F. Cohen, a former chairman of the SEC, to explore in depth what the responsibilities of auditors should be. This commission, consisting of three practicing accountants, a professor of accounting, a financial analyst, an attorney and a businessman, has recently published its preliminary conclusions and recommendations.

Although the Institute financed the operations of this commission, every effort was made to maintain its strict independence from the Institute. Its conclusions are totally

those of its members and were in no way dictated or influenced by the Institute or its officers or governing bodies. The preliminary recommendations of this commission, which will be the subject of public hearings, are already under intensive study within the Institute. We can assure you that all of the final recommendations will receive careful consideration and, while some are bound to be controversial, we expect that many will be implemented in the relatively near future.

As new issues have appeared, the Institute has moved promptly to deal with them. When the issue of questionable corporate payments became a subject of concern, the Institute's Auditing Standards Executive Committee took action and recently issued two pronouncements relating to the subject, Statement on Auditing Standards No. 16 (The Independent Auditor's Responsibility for the Detection of Errors or Irregularities) and Statement No. 17 (Illegal Acts by Clients) for the purpose of defining auditing responsibilities and procedures in this connection.

The Auditing Standards Executive Committee also recently issued a draft of a proposed statement concerning required communication to management of material weaknesses in internal accounting controls. Comments on the draft are being processed and a final pronouncement is expected to be forthcoming shortly.

In addition to these efforts, of course, much has happened in recent years -- and is happening -- to strengthen the reliability of financial statements. These developments are discussed in the Institute's memorandum, but a brief reference to some of them may be helpful:

1. It has become commonplace for corporations to have audit committees of the Board of Directors, providing additional protection for the auditor's independence of the corporate management. The Institute advocated audit committees long before they gained their current level of acceptance.

2. As a result of the Institute's efforts, nearly half the states have enacted statutes mandating continuing professional education requirements for CPAs as a condition to the continuing right to practice. In the remaining states, some of which are considering such legislation, the profession is offering programs on a voluntary basis in impressive quantities.

3. Firms have significantly expanded their training and quality control activities. In addition, the Institute has adopted, and is implementing, an extensive program, which has gained widespread support and participation, to review quality controls within firms.

4. Whenever there is a change in auditors for a publicly held company, any auditor-management disputes concerning

accounting matters must be publicly disclosed, thus strengthening the auditor's ability to maintain his independence and to resist management pressure.

The quality of the accountant's performance is influenced by a number of forces. There are the disciplinary procedures of the Institute, the state boards of accountancy and the state societies. The SEC, by rule-making and through administrative and injunctive proceedings against accountants, has exercised considerable influence on professional conduct. Private litigation, often seeking many millions of dollars in damages from auditors, has had a similar effect. The firms and individual accountants themselves, partially in response to these forces, but also in large measure because of their strong sense of professional responsibility, have steadily improved their standards and performance at substantial cost. The Commission on Auditors' Responsibilities confirmed the adequacy of this combination of forces: "On balance, we do not believe that major changes in the legal environment would produce significant benefits to society or to the profession."\*

The total effort now being made, combined with that which has been made in the past, is, in our estimation, impressive. There is strong reason to believe that the problems and abuses of the past decade will not recur in the future.

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\*The Commission on Auditors' Responsibilities: Report of Tentative Conclusions, p. 145.

The key question is whether the staff study's recommendations would in any way further the efforts of the FASB, the SEC and the profession to further enhance the reliability of financial statements and strengthen the auditing process.

While we disagree with a number of the recommendations of the staff study and we believe that many of the criticisms and concerns about the accounting profession reflected in the study are unwarranted, they all merit our prompt and careful attention and they will surely have it. We believe, however, that the private sector and the SEC, working jointly as they have for more than forty years, can and will effectively refine present accounting and auditing practices and adopt new ones to reflect the lessons of experience. This arrangement provides assurance that the quality of financial reporting by publicly owned corporations will meet the expectations of Congress and the investing public.

We submit that the expanded governmental role envisioned in the staff study would not significantly advance, and might even slow down, the progress being made. We repeat that we do not deny that some members of the profession have not fully met their responsibilities -- and that some problems still exist. We feel, however, that those problems have been identified and are being dealt with. Overall, we feel the accounting profession has compiled an excellent record of public responsibility

The profession's concern for the public interest has never been stronger than it is today, and our determination to improve our performance has never been greater.

The challenge before American business and the American accounting profession is a formidable one. Confidence in the corporate and professional leadership of our country is seriously lagging. But this trend can and I am confident will be reversed by the joint efforts of the governmental regulatory agencies, the business and professional communities, and the Congress.